***<u>Monthly Outlook, March, 2017: Unease Amidst All This Prosperity!</u>***

Despite equity markets hitting all-time highs recently, we are left with a feeling of unease about these markets: In our opinion, President Trump does not have a ***magic wand*** that he will simply be able to wave, and convert all the Cassandras to Pollyannas. Indeed, as earnings expectations still remain too high and valuations stretched, we think fundamentals are even more applicable now – especially if markets are to return to some ***modicum of reality.***

Economic data released in the United States was reasonable: US payrolls added ***235,000 jobs in February***, compared to a consensus expectation around 180,000 jobs. ***Private payrolls*** increased 227k jobs, as both goods producing (+95k) and service providing (+140k) sectors posted solid gains. Construction jobs rose +58k (helped mostly by warmer weather during the month), and education and health services rose +62k (despite uncertainty regarding the replacement of the previous President's eponymous health care legislation).

The politically sensitive ***unemployment rate*** dropped another tenth to ***4.7%***, while the more robust measure of underemployment (also called the U-6 measure) also dropped two-tenths to 9.2% for the month. Average Hourly Earnings rose 0.23% (m/m; ***y/y: 2.8%***) for the month – implying that labor markets might indeed be tightening somewhat as employers pay up to hire and retain workers with skills in demand.

While media coverage about the employment data has been ***unabashedly positive*** (almost on the verge of cheerleading), our own read of the data does suggest a nuanced ***loss of momentum*** in the trends we are seeing: To wit, the monthly average in jobs gained over the previous twelve months which stood at 260k in Feb, 2015 and 217k in Feb, 2016 ***declined*** to 196k for Feb, 2017. Similarly, the same measure for service providing sectors, which stood at 215k in Feb 2015 and 200k in Feb, 2016, also declined to 180k in Feb, 2017.

The real question is whether this loss of momentum is the result of employers finding it ***hard to fill open positions*** (as there are not enough qualified applicants) or whether there is something more endemic to the downshift: Perhaps it is as a result of ***slowly eroding demographics*** – as more and more baby boomers retire at an early age – or automation of many previously repetitive functions (even in the service sector). Regardless of the cause, it is interesting, that despite all the gushing coverage in the financial press, we have not seen any reports (to our knowledge) that seem to even touch on this topic.

In other economic news, ***survey indicators*** of both the manufacturing and service sector suggest better momentum: The Institute of Supply Management's Purchasing Managers' Index rose to a reading of 57.7 in early March from 56.0 in February. The New Orders component of the manufacturing survey revealed a jump in the index to 65.1 in March from 60.4 in February. The overall Non-Manufacturing Index (or NMI as it is called!) posted a reasonable gain to 57.6 in March from 56.5 in February. Here too, the new export orders component rocketed to 57.0 in March from a staid 48.0 in February.

Meanwhile, ***inflation readings*** seem to be quietly bubbling up: Consumer prices rose 0.6% in January (m/m; y/y: 2.5%) – the latest month for which data is available at the time of writing. The ex-food and energy measure of consumer prices (also called ***"core"***) rose 0.3% (m/m; ***y/y: 2.3%***) – easily above the self-imposed Federal Reserve Target of 2.0% inflation. However, the personal consumption expenditures deflator – a measure that is thought to be ***more robust*** as it uses a flexible weighting system as opposed to the former's fixed weight paradigm– also rose 0.3% (m/m; ***y/y: 1.7%***) during the month of January.

We are not at all suggesting that we are on the ***cusp of runaway inflation*** – far from it: We are however implying, that ***at the margin*** the news on the inflation front has ***started to deteriorate*** and ***bears watching*** (pun intended!). This is indeed, one of the reasons why, the Federal Reserve is likely to increase the Fed Funds Target when they meet later this week in March. Fed Chairwoman Janet Yellen said as much during a speech in Chicago earlier this month using the phrase "in which case, a further adjustment of the federal funds rate ***would likely be appropriate***".

As a result of these expectations getting priced into debt markets, ***bond yields have climbed***. Indeed, the US Treasury ten year is currently yielding 2.58% - a 2017 high. While many so called "experts" have tried to guesstimate the level at which a ***"bond bear market"*** would truly commence, (Bill Gross formerly PIMCO's star "bond king" thinks it is 2.6%, while Jeff Gundlach of Doubleline has suggested 3.0% for the ten year Treasury) we profess to do no such thing!

Increases in interest rates are a natural occurrence of deteriorating inflation fundamentals, as well as an increasing demand for capital – especially if the Trump Administration is able to lower tax rates, lift regulatory burdens, and launch a large infrastructure spending program. Many commentators have suggested that the Trump Administration might be able to ***"awaken the animal spirits"*** in corporate America, thus bringing about a Reagansque change in the economy! To this we say ***"be careful what you wish for"*** as interest rates are unlikely to stay low for the foreseeable future.

Farther afield, this week also sees an ***election in the Netherlands***. There are 28 (yes, twenty eight) parties vying for the elections including those with interesting names like 50plus, the Entrepreneur's Party, Free Thinking Party etc. The main contest for Parliament is between the ruling party (VVD) and the nationalist leaning PVV – whose leader ***Geert Wilders*** **-** is regarded as a Dutch version of Donald Trump. If the latter were to win enough seats to form a government, we could well see dramatic changes in Dutch policy, particularly as it ***relates to immigration***.

The French populace is also going to be at the hustings in April and May (with two rounds of elections slated to be held in late April and early May). Here too Marine Le Pen (of the National Front), who has been described by the mainstream media as a ***"firebrand right-winger"***, appears to be drawing support from younger voters who believe that "the system" has been rigged against them ***by the elites***. With a split in the center-left coalition that has governed France for many years, a win by the National Front would call into question the sustainability of the EU.

As if all of this were not enough, UK Prime Minister Theresa May is likely to ***invoke Article 50*** that begins the two-year timetable for the UK and the EU to negotiate the former's exit from the latter, sometime next week as well. It appears to us that ***attitudes have hardened*** on both sides of this issue – yet, again, bringing into sharp relief the mess that Europe has created for itself both from a fiscal as well as a regulatory standpoint. Amidst all this, Mario Draghi was almost crowing from the rooftops last week, declaring ***"victory from deflation"*** in a bout of self-congratulatory zeal!

Crude oil prices have hit an ***"air-pocket"***, declining significantly on fears of increased supply (US rig counts in Shale regions have edged up cautiously) amid unseasonably warm weather in North America (although our friends in the Northeast would hardly know it given Winter Storm Stella bearing down on them). As a result of the declines in prices of energy names recently, we have added to your exposure to this sector recently, fully believing that the recent weakness is a mere storm in the proverbial tea cup!

As equity markets have continued their merry making these past few months and risen to all-time highs, we are increasingly uncomfortable with their move – not just because we are ***"worry warts"***, but because of our long-held conviction that ***fundamentals do eventually matter.*** For better or worse, our approach to markets does have a strong vein of contrarian thought built into it, and while it often makes for a lonely disposition, we remain steadfast in the belief that as ***stewards of client wealth***, it is often better to worry about return ***of*** capital than to worry just about return ***on*** capital! Unease amidst all this prosperity, indeed!

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